Collins Barrow
Chartered Accountants

Tax Alert

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Canada-U.S. Income Tax Convention Passes Critical Step

On September 23, 2008, the United States Senate, by unanimous consent, approved the Fifth Canada-U.S. Protocol (the Protocol) to the Income Tax Convention between Canada and the U.S. (the Treaty). This approval represents the final hurdle for the Protocol in the ratification process as Canada has already ratified the Protocol with Bill S-2 receiving royal assent on December 14, 2007. The concluding steps in the ratification process are the signature by the President and the exchange of instruments between Canada and the U.S., which is anticipated to occur prior to the end of the year.

See the Fall 2007 issue of *Tax Alert* for our discussion of the Treaty amendments following the release of the Protocol provisions on September 21, 2007.

Notably, the provisions of the Protocol come into force on the date that notification instruments are exchanged. However, there are many exceptions as to the coming into force for many of the Protocol's significant provisions. With the expected exchange to occur on or before December 31, 2008, the following Protocol provisions will come into force on the following dates:

Provision	***Effective Date***
Withholding Tax of Related Party Interest	2008 – 7% (Retroactive to Jan. 1) 2009 – 4% 2010 – 0%
Limitation on Benefits	January 1, 2009
Permanent Establishments (Services and Attribution of Profits)	January 1, 2010
LLC, S-Corp (Entitlement to Treaty Benefits)	First day of second month that begins after the date the Protocol comes into force
ULC (Denial of Treaty Benefits)	January 1, 2010

On July 10, 2008, the U.S. Treasury department, in connection with the U.S. Senate Foreign Relations Committee, issued a technical explanation on the Protocol, as did the U.S. Joint Committee on Taxation. The technical explanations serve as a paper of mutual understanding between both countries as Canada had the opportunity to review and comment. This article will shed some renewed light on the above provisions and the impact associated with their coming into force.

Treatment of hybrid entities (LLCs, S-Corps, ULCs)

The U.S. members of a Limited Liability Corporation ("LLC") will be eligible to claim treaty benefits on amounts received or realized by the LLC. The LLC would be required to file a tax return and other documentation to support the claim.

U.S. S-Corporations will be treated as "fiscally transparent entities" for U.S. tax purposes but will be recognized by Canada as entities that may claim treaty benefits.

Unlimited Liability Corporation ("ULC") payments of dividends or other payments to a U.S. parent or resident will not be entitled to treaty benefits, thus increasing the withholding amount of dividends from 5-15% to 25%. This is probably the most contentious issue for U.S. companies carrying on business in Canada through ULCs.

There may be a need for restructuring before the treaty benefit denial rules come into effect at the earliest date of January 1, 2010. There are alternatives to this structure that can be implemented to address this situation. Your Collins Barrow advisor can elaborate on these alternatives.

Limitation on benefits

The existing limitation on benefits is currently applicable for U.S. tax purposes. However, with the coming into force of the Protocol, the article will be applicable for Canadian tax purposes.

Central to the application of the limitation on benefits is the definition of the term "qualifying person." In order to receive treaty benefits, a person must be a "qualifying person.' The tests for determining a "qualifying person" can be rigorous and go beyond the scope of just the residency of the person or entity. This provision of the Protocol is expected to come into force on January 1, 2009 at the earliest. It contains an array of defined terms that have for the most part been provided for in the technical explanations, but can have significant impact on treaty benefits if a person or entity is found not to be a "qualifying person."

Permanent establishments

The Protocol adds new rules affecting the services provided by enterprises in the other contracting country. Briefly stated, those rules provide that an enterprise will be deemed to have a permanent establishment in the other country if it provides services in the other country and:

- the services are performed in the other country by an individual who is present in the other country for a cumulative total of 183 days or more in any 12-month period, and during that 12-month period more than 50% of the gross active business revenue consists of income derived from the services performed in the other country by the individual; or
- the services are provided in the other country for an aggregate of 183 days or more in any 12-month period with respect to the same or a connected project for customers resident in, or permanent establishments situated in, that other country.

These new rules, which are expected to apply as early as January 1, 2010, will have a major impact on businesses that provide cross-border services. There may need to be drastic changes from a logistical and administrative standpoint, along with continued monitoring of projects and personnel to avoid a default in the 183-day test.

Withholding tax – interest and guarantee fees

Under the provisions of the Protocol, withholding tax on interest, other than contingent interest, paid between related parties resident in Canada and the U.S. will be reduced as per the table above. Note that unrelated interest payments made from Canadian entities to non-residents are exempt from withholding tax through Canadian tax legislation with an effective date of January 1, 2008.

With the expected ratification process to be completed before the end of the year, many taxpayers have overpaid on their withholdings because of the potential retroactive treatment. Those taxpayers will be interested in receiving a refund on the overpayments and may also be interested in the treatment of retroactive payments in financial statement presentation.

If you do any business in the U.S., contact your Collins Barrow advisor to better understand how the Protocol may affect you.

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The Five "W's" of Tax Free Savings Accounts (TFSAs)

What is a TFSA?

In introducing the TFSA concept in the 2008 Federal Budget, the Federal Government proposed a new way for Canadians to save money. The TFSA structure allows taxpayers to save or invest their money in eligible TFSAs without paying any income tax on the investment income or capital gains earned. Taxpayers can also withdraw from their TFSAs on a tax-free basis.

When can you start a TFSA?

Effective January 1, 2009, taxpayers can contribute up to $5,000 per year, though this limit may increase in the future in response to inflation. The $5,000 annual limit is in addition to the taxpayer's RRSP Contribution limit. Any unused contribution room may be carried forward indefinitely.

Where can you set up a TFSA?

TFSAs may be set up by any financial institution, including investment brokerage firms, insurance companies, mutual fund dealers, trust companies and chartered banks.

Eligible investments include most investments that can currently be held in an RRSP. These may include certain savings accounts, GICs, mutual funds, stocks and bonds.

Who is eligible for a TFSA?

In order to be eligible to set up a TFSA, a taxpayer must:

- be at least 18 years old;
- hold a valid Social Insurance Number; and
- be a Canadian resident.

Why should you set up a TFSA?

There are many benefits to setting up a TFSA. Following are some of those benefits:

- Your investments will grow faster because both investment income and capital gains earned within TFSAs are tax-free.
- TFSAs are more flexible than RRSPs and RESPs. They can help you save for any financial goal at any point in the future, be it a home, an automobile or a vacation.
- You can withdraw any amount of funds at any time without paying any income tax.
- The amount withdrawn from a TFSA can be put back into a TFSA

at any time without reducing your annual contribution limit.

- Having a TFSA will not affect your eligibility for federal income-tested benefits, such as the Canada Child Tax Benefit and the Guaranteed Income Supplement.
- Your TFSA assets are transferable to your spouse or common law partner upon your death.
- TSFAs encourage you to start saving early to meet your future demands without worrying about income taxes on your earnings and withdrawals.

It should be noted that TFSA contributions are not tax deductible. Despite this disadvantage, however, TFSAs are suitable for Canadian taxpayers of all income levels and ages. Contact your Collins Barrow advisor for more information on TFSAs in the context of your own financial circumstances.

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New Rules and Options for LRSPs and LIFs

Individuals who have left or changed their jobs will often have their pension benefits transferred to a Locked-in Retirement Savings Plan (LRSP). This LRSP will be governed by the same federal or provincial pension benefits legislation that governed the original pension.

When the individual is ready to receive retirement income from the plan (sometime between the ages of 55 and 71), one option is to transfer the funds to a Life Income Fund (LIF). The LIF will then act similarly to a regular pension and pay out an authorized annual amount, which will be taxed as pension income to the recipient. The individual cannot increase the amount of pension income to use additional funds from the LIF for such things as paying down personal debt, home purchase, etc. There are very strict limits to receiving additional payments from the LIF, which relate to ceasing residency in Canada and illnesses that will considerably reduce life expectancy. Thus, the LIF is significantly less flexible than a Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF), which have no limits on the amount that can be withdrawn in a year.

As of May 8, 2008, new rules were introduced for LIFs that stem from federally regulated pensions. These new rules will enable individuals to withdraw funds in excess of the annual limit. There are 3 possible ways to access additional funds. They are:

1. Individuals who are 55 or older and have funds in a federally regulated LRSP or LIF can withdraw all of the funds *or* transfer the funds to an unlocked tax-deferred plan (such as an RRSP or RRIF) if the amount in the LRSP or LIF is less than $22,450 (this threshold will be adjusted annually). If all of the funds are withdrawn, the amount received is included in the income of the individual. There is no immediate tax consequence on funds transferred to an RRSP or RRIF. Any amounts subsequently received out of the RRSP or RRIF are included in the income of the individual.

2. Individuals 55 or older can convert up to 50% of the LIF holdings into an unlocked tax-deferred plan such as an RRSP or RRIF. The funds remaining in the LIF will be subject to the normal annual withdrawal rules. Funds transferred to an RRSP or RRIF will provide greater flexibility to the individual since there is no limit on the amount of funds that can be withdrawn in the current or any future year. This conversion is only available once for each LIF. The following timing rules apply:

    - For LIFs in existence at May 8, 2008, the conversion can be done as soon as the financial institution holding the LIF is able to comply with these new rules.
    - For LIFs created after May 8, 2008, this option must be done within 60 days of the creation of the LIF. There are transitional rules that increase this time limit where the steps in the conversion commenced prior to May 8, 2008.

3. Individuals who can demonstrate financial hardship will be able to withdraw up to $22,450 per calendar year. Financial hardship is defined to occur as a result of:

    - low income, which is currently set at income less than $33,675; or
    - high disability or medical related costs that are expected to exceed 20 percent of income for the year.

Funds held in an LIF are secure from creditors (such as in the case of bankruptcy). This is generally not the case for funds held in an RRSP or RRIF (depending on the province in which the individual resides). While unlocking funds held in an LIF will provide greater flexibility to the individual, the funds may then be exposed to creditors.

An individual wishing to remove funds from an LIF under one of the above options will need to provide attestation from his or her spouse or common-law partner assenting to the transfer or withdrawal. The individual must also attest that he or she:

1. is aware of the potential loss of protection from creditors;
2. understands that any funds withdrawn may be taxable; and
3. understands the need to seek professional advice about the financial and legal implications.

If you currently have an LRSP or LIF, you should consult with your Collins Barrow advisor to determine if these new rules and options apply to you.

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Scientific Research and Experimental Development: 2008 Federal Budget Enhancements

Canadian businesses that conduct scientific research and experimental development (SR&ED) in an effort to discover new, improved, or technologically advanced products or processes will have increased access to Investment Tax Credits (ITCs). The SR&ED incentives provided by the federal and provincial governments are considered among the best in the world. These were further enhanced by changes in the 2008 Federal Budget.

Corporations earn ITCs on qualified SR&ED expenditures at the rate of 35% or 20%. The maximum expenditure limit for the 35% ITC, which is available to Canadian Controlled Private Corporations (CCPCs), was increased to $3 million from $2 million as of February 26, 2008. The $3 million expenditure limit is phased-out when the prior year's taxable income (including taxable income of associated companies) exceeds $400,000, or when taxable capital (also computed on an associated company basis) exceeds $10 million. It is reduced by $10 for every dollar of taxable income and by $0.075 for every dollar of taxable capital employed in Canada (TCEC) above the thresholds.

Based on the Budget changes, the extra 15% credit is eliminated at taxable income of $700,000 and TCEC of $50 million. Prior to the Budget, the thresholds were $600,000 and $15 million respectively.

CCPCs that qualify for the 35% ITC are eligible to receive a 100% refund of the credits earned on current SR&ED expenditures in excess of the amount used to reduce tax otherwise payable.

The following table illustrates the maximum refundable ITCs available to a CCPC for taxation years ending after February 25, 2008. The table assumes an SR&ED current expenditure of $3 million and a refundable ITC rate of 35%.

Taxable Capital	Taxable Income			
	$400,000	$500,000	$600,000	$700,000
$10,000,000	$1,050,000	$700,000	$350,000	Nil
$20,000,000	$787,500	$525,000	$262,500	Nil
$30,000,000	$525,000	$350,000	$175,000	Nil
$40,000,000	$262,500	$175,000	$87,500	Nil
$50,000,000	Nil	Nil	Nil	Nil

The taxable capital and taxable income figures in the table relate to the prior taxation year of all associated corporations. For taxation years that straddle the Budget date, the expenditure limit increase and the taxable income and taxable capital phase out limits will be pro-rated based on the number of days in the taxation year that are after February 25, 2008.

Both Quebec and Ontario have followed the federal increase to the expenditure limit.

In addition to the enhanced ITCs for CCPCs, the budget announced the following:

- The ITC carry forward period was increased from 10 years to 20 years for unused ITCs earned in the 1998 to 2005 taxation years.
- Qualified expenditures will include certain salaries or wages incurred in respect of SR&ED carried on outside of Canada after February 25, 2008. The expenditures are limited to 10% of salaries attributable to SR&ED carried on in Canada. The 10% limit is pro-rated for the number of days in the taxation year after February 25, 2008.
- There are new improvements to the administration of the SR&ED incentive program, including the simplification of the SR&ED claim form.

Contact your Collins Barrow advisor to help determine if your Scientific Research & Experimental Development might qualify for these newly enhanced incentives.

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